IT 01-2
Tax Type: Income Tax
Issue: Federal Change (Corporation)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS v. **ABC INSURANCE COMPANY,** Taxpayer	No. 99-IT-0000 FEIN: 00-0000000 TYE: 12/31/94

RECOMMENDATION FOR DISPOSITION
UPON DEPARTMENT'S MOTION TO DISMISS

Appearances: David P. Dorner, Senior Counsel, Income Tax for the Illinois Department of Revenue; Mary N. Belgrade and Lee S. Mickus for ABC Insurance Company.

Synopsis:

This matter comes on pursuant to the Department's Motion to Dismiss taxpayer's protest of the Notice of Claim Denial issued for the tax year ending 12/31/94. The Department motion is premised upon the doctrine of *res judicata* and 5/2-619(a)(4) of the Illinois Code of Civil Procedure. After consideration of the Department's motion, the taxpayer's response and supporting memorandum of law and the Department's reply memorandum, it is my recommendation that the Department's Motion to Dismiss should be granted.

FINDINGS OF FACT:

1. On February 11, 1997, the Department issued a Notice of Deficiency to the taxpayer for the tax years ending 1993 and 1994. This NOD proposed an assessment for 1994 based upon an adjustment to the taxpayer's addition modification for federal tax-exempt interest under Section 203(b)(2)(A) of the Illinois Income Tax Act ("IITA") ("addition modification"). The Department required the taxpayer to add-back 100% of its federal tax-exempt interest rather than 85% as originally filed. *See,* Dept.'s Motion Exh. A & B.

2. On March 27, 1997, the taxpayer timely protested the Department's Notice of Deficiency and requested an administrative hearing. Dept.'s Motion Exh. C.

3. During the course of the administrative proceeding, the Department and the taxpayer stipulated to the facts and submitted the case for hearing before the Administrative Law Judge. Dept.'s Motion Exh. C & D.

4. The Administrative Law Judge recommended a disposition in favor of the Department and thereafter on October 16, 1997, the Director of Revenue adopted the recommendation. Dept.'s Motion Exh. E & F.

5. On December 22, 1997, the taxpayer filed a complaint in the Circuit Court of Lake County for administrative review of the Department's final decision ("Lake County case"). Dept. Motion Exh. G. In its complaint, taxpayer alternatively argued that the correct addition modification was either 0% or 85% of its federal tax-exempt interest. *See,* Exh J, Part V and Taxpayer's Response to Dept.'s Motion.

6. On October 26, 1998, the Circuit Court of Lake County affirmed the Department's final decision. Dept. Motion Exh. I.

7. Taxpayer did not appeal the Circuit Court of Lake County's decision entered on October 26, 1998. This decision found in favor of the Department on the addition modification issue for the tax year ending 1994. *See*, Taxpayer's responsive memorandum of law.

8. On September 14, 1998, prior to the Circuit Court of Lake County's decision, the taxpayer filed an amended tax return claiming a refund for the tax year ending 1994. Dept. Motion Exh. J. This 1994 amended return adjusted the taxpayer's addition modification for federal tax-exempt interest from 85%, as originally filed, to 0%. Dept. Motion, Exh. J, Line 2a. The position taken in the amended return related to the first section of taxpayer's complaint in the Lake County case that alleged it was not required to add back any of the federal tax-exempt interest on its Illinois tax return. Dept.'s Motion, Exh. G; Taxpayer Response to Motion to Dismiss.

9. On August 6, 1999, the Department denied the Taxpayer's amended tax return. Dept.'s Motion, Exh. K.

10. On October 1, 1999, the taxpayer protested the Department's Notice of Denial. In this protest the taxpayer argued that the correct addition modification was 85% of its federal tax-exempt interest. Dept.'s Motion, Exh. M.

11. Taxpayer added back 85% of its federal tax-exempt interest on its original IL-1120. This 1994 IL-1120 was the subject of the Department's final decision

issued on October 16, 1997 and the subsequent Lake County administrative review case. Dept.'s Motion Exh. M.

CONCLUSIONS OF LAW:

In its Motion to Dismiss, the Department moves to have the taxpayer's protest dismissed pursuant to the doctrine of *res judicata*, and 5/2-619(a)(4) of the Illinois Code of Civil Procedure. Under the doctrine of *res judicata*, a final judgment on the merits rendered by a court of competent jurisdiction acts as a bar to a subsequent suit between the parties involving the same cause of action. River Park, Inc. v. City of Highland Park, 184 Ill. 2d 290, 301(1998). The following three requirements must be satisfied for the doctrine of *res judicata* to apply: 1) there was a final judgment on the merits rendered by a court of competent jurisdiction, 2) there is an identity of parties or their privies, and 3) there is an identity of causes of action. Id. at 301.

Clearly, there was a final judgment on the merits by a court of competent jurisdiction. On October 26, 1998, the Circuit Court of Lake County entered judgment in favor of the Department and against the taxpayer concerning the issue of whether the taxpayer added back the correct percentage of federal tax-exempt interest income for the tax year ending 1994. Taxpayer chose not to appeal the Circuit Court of Lake County's decision. Further, there is an identity of the parties since the taxpayer and the Department were the same litigants in the Lake County case.

Taxpayer argues that under Commissioner of Internal Revenue v. Sunnen, 333 U.S. 591, 68 S.Ct. 715 (1948) the prior determination by the Lake County Circuit Court

is not conclusive as to the 1994 tax year. In its brief, taxpayer claims that the Supreme Court in Sunnen states that:

> "Parties are free to litigate points which were not at issue in the first proceeding, even though such points might have been tendered and decided at that time. … in this sense, res judicata is usually and more accurately referred to as estoppel by judgment, or collateral estoppel. It must be confined to a situation where the matter raised in the second suit is identical in all respects with that decided in the first proceeding and where the controlling facts and applicable legal rules remain unchanged. If the legal matters determined in the earlier case differ from those raised in the second case, collateral estoppel has no bearing on the situation. And where the situation is vitally altered between the time of the first judgment and the second, the prior determination is non conclusive."
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> Taxpayer's Brief p. 2 *quoting* Sunnen, *supra*.

Taxpayer argues that *res judicata* should not apply in this matter because the Department's interpretation of the law has vitally altered since the Lake County case was decided in the Department's favor. This change in interpretation is due to the decision rendered in Sentry Insurance, a Mutual Insurance Company, Plaintiff, v. Kenneth Zehnder, Director of the Illinois Department of Revenue, and Judy Baar Topinka, Treasurer of the State of Illinois, Defendants, Case No. 98L50264 (June 15, 1999) wherein a Cook County Circuit Court judge ruled that "the proper addition modification under Section 203(b)(2)(A) of the IITA for interest on federally tax-exempt bonds is equal to … 85% of the interest on such bonds acquired after August 7, 1986."

Taxpayer's quotation of the Court's analysis in Sunnen is misleading, however, since the Court's discussion related to an instance where the second action between identical parties was premised upon a different cause or demand. *See*, Sunnen, at 597-600. The Court stated that under those circumstances, the prior judgement would act as a collateral estoppel only as to those matters in the second proceeding which were actually

presented in the first case. Id. at 598. If two cases involve income taxes in different taxable years, collateral estoppel must be "confined to situations where the matter raised in the second suit is identical in all respects with that decided in the first proceeding and where the controlling facts and applicable legal rules remain unchanged." Id. at 599, 600. Changes or development in the controlling legal principles could make that prior determination obsolete at least "*for future purposes*." Id. at 599 (emphasis added).

Res judicata and collateral estoppel are not identical concepts. In its discussion of the doctrine of *res judicata*¸ the United States Supreme Court in Sunnen stated as follows:

> "The rule provides that when a court of competent jurisdiction has entered a final judgment on the merits of a cause of action, the parties to the suit and their privies are thereafter bound 'not only as to every matter which was offered and received to sustain or defeat the claim or demand, but as to any other admissible matter which might have been offered for that purpose.' (citations omitted). The judgment puts an end to the cause of action, which cannot again be brought into litigation between the parties upon any ground whatever, absent fraud or some other factor invalidating the judgment." (citations omitted).
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> Sunnen, at 597.

Further, the Court observed that with regards to the federal income tax area, "each year is the origin of a new liability and of a separate cause of action." Id. at 598. "Thus if a claim of liability or non-liability relating to a particular tax year is litigated, a judgement on the merits is res judicata as to any subsequent proceeding involving the same claim and the same tax year." Id.

It is undisputed that both the Notice of Deficiency at issue in the Lake County case and the Notice of Claim Denial which is the subject of this proceeding relate to the

tax year ending 12/31/94. The only issue, therefore, that must be determined is whether there is an identity of the causes of action.

To determine whether there is an identity of the causes of action, Illinois courts have adopted the transactional test. Under the transactional test a second suit is barred if it is based on the same core of operative facts as the first suit. River Park, Inc. v. City of Highland Park, 184 Ill.2d 290, 309 (1998). In River Park, Inc., the court observed:

> What factual grouping constitutes a transaction are (*sic)* to be determined pragmatically giving weight to such considerations as whether the facts are related in time, space origin, or motivation, whether they form a convenient trial unit, and whether their treatment as a unit conforms to the parties expectations or business understanding or usage." River Park Inc., at 311, *citing* Restatement (Second) of Judgments § 24m at 196 (1982).

The case at bar and the Lake County case both involve the same core operative facts, i.e., the 1994 Illinois tax returns, and the identical issue, specifically, the taxpayer's addition modification of 85% of its federal tax-exempt interest. For example, the issue as stipulated by the parties in the previous cause of action was as follows:

> Whether the Department was correct in adjusting the Section 203(b)(2)(A) addition modification for tax-exempt interest of ABC Insurance Company ("ACIC") unitary business group for the tax years ending 12/31/93 and 12/31/94 described in the notice of deficiency dated July 27, 1995, from 85% to 100% of the interest received by the two members of the ACIC's group that are property and casualty insurance companies and are subject to IRC Section 831 to 835 [the 15 percentage point difference between the addition modification reported by ACIC and that proposed by the Department related to IRC Sec. 832 (b)(5)].

(See, Addendum to Stipulation of Facts, Exh. C to the Department's Motion to Dismiss).

In the case at bar, the taxpayer stated the issue in its protest as follows:

> Whether the Department was correct in adjusting the [IITA] Section 203(b)(2)(A) addition modification for tax exempt interest of ABC Insurance Company ("ACIC") unitary business group for the tax years

> ending 12/31/94 described in the notice of deficiency dated July 27, 1995, from 85% to 100% of the interest received by the two members of the ACIC's group that are property and casualty insurance companies and are subject to IRC Section 831 to 835.

(*See*, Taxpayer's Protest dated 10/1/99).

Additionally, in the Lake County administrative review case taxpayer alternatively argued that either 85% or 0% of its federal tax-exempt interest was the correct addition modification. After considering these arguments, the Lake County Circuit Court held in favor of the Department. Clearly, with regards to the tax year ending 1994, taxpayer is attempting to litigate the same issue twice. The doctrine of *res judicata* and Section 5/2-619(a)(4) of the Illinois Code of Civil Procedure, however, preclude such repetitious suits.

It should also be noted that taxpayer has not filed a proper amended return in this matter. Its amended return filed on September 14, 1998 took the position that it was not required to add back any of its federal tax-exempt interest under Section 203(b)(2)(A), i.e., it adjusted the addition modification from 85% of its federal tax-exempt interest as originally filed to 0%. Thereafter, taxpayer filed a protest to the Department's Notice of Claim Denial wherein it asserted that the correct addition modification under Section 203(b)(2) was 85% of the federal tax-exempt interest.

Under Sections 909(d) and 1401 of the IITA taxpayer should have filed an IL-1120-X to amend its original tax return and reflect the legal position taken in its protest. *See*, 35 **ILCS** 5/909(d) and 35 **ILCS** 5/1401; *See also*, 86 Ill. Admin. Code § 100.9400. Additionally, the 1994 IL-1120 instructions, which have the force of a Department regulation pursuant to IITA Section 1501(a)(19) also require the taxpayer to use Form IL-1120-X to report corrections or changes in Illinois tax liability. *See*, IL-1120

Instructions, page 2, Section 8; *See also*, Dow Chemical v. Department of Revenue, 224 Ill. App. 3d 263 (1st Dist. 1991)(taxpayers have an "affirmative duty" to file a timely claim for refund). In any event, whether the addition modification is 0% or 85% of its federal tax-exempt interest, the taxpayer's attempt to litigate this issue once again is barred pursuant to the doctrine of *res judicata.*

Finally, the taxpayer argues that since the Department has changed its position on this legal issue, equity would entail that it be granted relief in this matter. An administrative law judge at the Department, however, is not empowered by statute with the authority to grant equitable relief. *See*, 5 **ILCS** 100/10-50 and 86 Ill. Admin. Code § 200.165.

Wherefore, it is my recommendation that the Department's Motion to Dismiss should be granted.

Date: February 23, 2001

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Administrative Law Judge